

IT 04-5

Tax Type: Income Tax

**Issue: Validity of Regulation
Commerce Clause (U.S. Const.) Controversy**

**STATE OF ILLINOIS
DEPARTMENT OF REVENUE
OFFICE OF ADMINISTRATIVE HEARINGS
CHICAGO, ILLINOIS**

THE DEPARTMENT OF REVENUE)	Docket No.	01-IT-0000
OF THE STATE OF ILLINOIS)	FEIN	00-0000000
v.)	Tax Years	2/28/94 & 2/28/95
ABC, INC. & AFFILIATES,)	John E. White,	
Taxpayer)	Administrative Law Judge	

RECOMMENDATION FOR DISPOSITION

Appearances: Jordan Goodman and Fred Marcus, Horwood, Marcus & Berk, Ltd., appeared for ABC, Inc. & Affiliates; Ronald Forman and Deborah Mayer, Special Assistant Attorneys General, appeared for the Illinois Department of Revenue.

Synopsis:

This matter involves the Illinois Department of Revenue's ("Department") denial of refunds that ABC, Inc. & Affiliates ("taxpayer" or "the ABC group") sought when it¹ filed amended returns regarding tax years ending in 1994 and 1995. On those amended returns, taxpayer changed the way it calculated the denominator of its sales factor. On its original returns, taxpayer calculated the denominator using the net receipts (i.e., profit), from its securities sales, which method is consistent with Illinois Income Tax Regulation ("IITR") § 100.3380(c)(5). On its amended returns, taxpayer measured its sales factor using the gross receipts from its sales of securities.

¹ For convenience, I will refer to ABC, Inc. & Affiliates in the singular throughout this recommendation.

The hearing was held at the Department's offices in Chicago. There are three issues: whether IITR § 100.3380(c) applies to the income at issue; whether that regulation is valid; and if it is, whether its application to the income here violates the Uniformity Clause of the Illinois Constitution. After considering the evidence adduced at hearing, I am including in this recommendation findings of fact and conclusions of law. I recommend the issues be resolved in favor of the Department.

Findings of Fact:

Facts Regarding Taxpayer's Business Organization & Operations

The ABC Group, Inc.

1. The ABC Group, Inc. ("Company") was originally incorporated under New York law on June 25, 1981. The Company was reincorporated under Delaware law in 1987. Stip. ¶ 1.
2. The Company maintains its headquarters in Anywhere, Florida. Stip. ¶ 2.
3. The Company is a holding company. Stip. ¶ 3.
4. The Company's primary subsidiaries are ABC, Inc., XYZ Corp., and MMM Corp. (collectively, "Primary Subsidiaries"). Stip. ¶ 4. The Company owns all the capital stock of its Primary Subsidiaries. Stip. ¶ 8.
5. ABC, Inc. ("ABC") is a broker-dealer providing discount brokerage services. Stip. ¶ 5.
6. XYZ Corp. ("XYZ") is a broker-dealer providing securities clearance for ABC and other correspondent broker-dealers. Stip. ¶ 6.
7. MMM Corp. ("MMM") is a broker-dealer that is a specialist on the floor of the New York Stock Exchange ("NYSE"). Stip. ¶ 7.

ABC

8. ABC was incorporated under New York law on March 1, 1974. Stip. ¶ 9.
ABC maintains its headquarters in New York, New York. Stip. ¶ 10.
9. ABC has been a member organization of the NYSE since May 2, 1974.
Stip. ¶ 11.
10. ABC is a member of the National Association of Securities Dealers (“NASD”). Stip. ¶ 12.
11. ABC is registered as a broker-dealer with the Securities and Exchange Commission (“SEC”). Stip. ¶ 13.
12. ABC offers brokerage services at substantially discounted commission rates to individual investors. Stip. ¶ 14.
13. ABC was the first NYSE member to offer substantially discounted commission rates to individual investors following the SEC’s elimination of fixed commission rates on securities transactions on May 1, 1975. Stip. ¶ 15.
14. ABC’s discount brokerage service is based on the principal that there are many investors who wish to conduct their own research and make their own investment decisions, and do not wish to pay for education or assistance. Stip. ¶ 16.
15. ABC reaches the self-directed investor through a combination of customer referrals and national and regional advertising (generally in financially oriented publications, radio and television). Stip. ¶ 17.
16. ABC has an extensive branch office system for the many investors who prefer to be geographically close to their broker. Stip. ¶ 18.

17. ABC's branch offices provide ABC with a presence in the community. Stip. ¶ 19.
18. As of February 28, 1994, ABC had 97 branch offices located throughout the District of Columbia and 33 states, including Illinois. Stip. ¶ 20.
19. ABC's clients are assigned their own Account Executive. Stip. ¶ 21.
20. ABC has a policy against Account Executives giving investment advice or opinions. Stip. ¶ 22.
21. ABC executes orders for its customers in listed and unlisted common and preferred stocks (i.e., "equity securities"), corporate and government debt instruments (i.e., "debt securities" or "fixed-income securities"). Stip. ¶ 23.
22. After an Account Executive gives the customer the price information for the security transaction, the Account Executive takes the customer's order and executes and confirms (both verbally and in writing) the transaction. Stip. ¶ 24.
23. To ensure the best execution of a customer's order, ABC has direct wire access to the trading floors of all major exchanges and interfaces electronically with the latest automated execution and order routing facilities. Stip. ¶ 25.
24. When acting as the customer's agent in a brokerage transaction, ABC receives commission income from the execution of the customer's security orders. Stip. ¶ 26.
25. ABC is the introducing broker when it acts as the customer's agent in a brokerage transaction. Stip. ¶ 27.
26. An introducing broker is a broker-dealer firm that accepts customer orders but elects to clear the orders through another broker for cost efficiencies (for

- example, not having to perform all of the clearance functions on a small volume of business, thereby eliminating many fixed costs). Stip. ¶ 28.
27. The clearing broker-dealer processes and settles the customer transactions for the introducing broker and usually maintains detailed customer records. Stip. ¶ 29.
28. Transactions executed by ABC are cleared by XYZ Corp. Stip. ¶ 30.
29. ABC acts as a principal in certain types of transactions, including sales of fixed-income securities. Stip. ¶ 31.
30. With respect to these principal transactions, ABC does not earn a commission, but rather recognizes gain or loss based on the difference between the selling price and its cost price of the security. Stip. ¶ 32.
31. The securities that ABC sold to its customers in principal transactions were the securities that XYZ kept on its books. Stip. ¶ 33.
32. If a customer of ABC wants to buy a debt security, ABC may either (i) buy it for the customer in exchange for a commission; or (ii) act as a principal in the transaction and offer to sell a debt security that XYZ bought on its own behalf (by agreement, ABC could offer to sell debt securities kept on XYZ's books), at a price higher than what was originally paid for it, thus earning the markup. Stip. ¶ 34.
33. ABC's customers receive trade confirmations that disclose if ABC acted as a principal or agent. Stip. ¶ 35.

XYZ

34. XYZ was incorporated under New York law on December 22, 1978. Stip. ¶ 36.
35. XYZ maintains its headquarters in New York, New York. Stip. ¶ 37.
36. XYZ is a member organization of the NYSE. Stip. ¶ 38.
37. XYZ is a member of the NASD. Stip. ¶ 39. XYZ is registered as a broker-dealer with the SEC. Stip. ¶ 40.
38. XYZ clears securities transactions for (1) customers of ABC, and (2) customers introduced by other brokerage firms and by banks (the introducing party is commonly known as a “Correspondent Broker”). Stip. ¶ 41.
39. A clearing broker is a broker-dealer who receives and executes customers’ instructions, prepares trade confirmations, settles the money related to the trades, arranges for the physical movement of the securities, and shares responsibility with the introducing brokers for compliance with regulatory requirements. Stip. ¶ 42.
40. When a customer of ABC or of a Correspondent Broker opens an account, XYZ, as agent for ABC or the Correspondent Broker, physically maintains the account. Stip. ¶ 43.
41. XYZ clears all securities transactions for ABC’s customers. Stip. ¶ 44.
42. XYZ carries accounts and clears transactions for 179 Correspondent Brokers. Stip. ¶ 45.
43. To ensure the best execution of a customer’s order, XYZ has direct wire access to the trading floors of all major exchanges and interfaces electronically with the latest automated execution and order routing facilities. Stip. ¶ 46.

44. XYZ's Correspondent Brokers may effect transactions on either a cash or a margin basis. Stip. ¶ 47.
45. In an account authorized for margin trading, XYZ may lend its customers an amount up to that permitted by the Federal Reserve Board, which in 1994, was 50% of the market value of the securities purchased. (Federal Reserve Board Regulation T). However, the amount of the loan is also subject to NYSE margin requirements and XYZ's internal policies, which in some instances are more stringent than Regulation T and NYSE requirements. Stip. ¶ 48.
46. XYZ makes money by lending funds to customers to buy securities on margin. Stip. ¶ 49.
47. XYZ also earns a commission, called a clearance fee, when it settles the transaction between the parties. XYZ's clearance fee is part of the commission charge that the customer pays to the introducing broker. Stip. ¶ 50.
48. XYZ also acts as a principal with respect to certain types of transactions, including sales of fixed-income securities. Stip. ¶ 51.
49. In acting as a principal, XYZ held debt securities primarily for sale to customers. Stip. ¶ 52.
50. With respect to these principal transactions, XYZ does not earn a commission, but rather recognizes gain or loss based on the difference between the selling price and its cost price of the security. Stip. ¶ 53.
51. If a customer of XYZ wants to buy a debt security, XYZ may either (i) buy it for the customer in exchange for a commission; or (ii) buy it on XYZ's

behalf and sell it to the customer at a higher price, thus earning the markup. Stip. ¶ 54.

52. XYZ's customers receive trade confirmations that disclose if XYZ acted as a principal or agent. Stip. ¶ 55.

MMM

53. MMM was incorporated in New York on September 10, 1982. Stip. ¶ 56.

54. MMM maintains its headquarters in New York, New York. Stip. ¶ 57.

55. MMM is a member organization of the NYSE. Stip. ¶ 58.

56. MMM is registered as a broker-dealer with the SEC. Stip. ¶ 59.

57. MMM conducts specialist operations on the floor of the NYSE. Stip. ¶ 60.

58. A specialist is a broker-dealer authorized by an exchange to be a party through which all trading on the floor of the exchange in a particular security is transacted. Stip. ¶ 61.

59. A specialist provides for a fair and orderly market for the selected list of securities it is authorized to trade. Stip. ¶ 62.

60. The specialist must generally be ready to take the other side of a transaction if other buyers or sellers are not available. Stip. ¶ 63.

61. A specialist is a company in the business of trading listed securities. Stip. ¶ 64.

62. Every company listed on the NYSE is represented by a specialist firm that is responsible for the trading of that company's stock. Stip. ¶ 65.

63. MMM consists of specialists who are members of the NYSE that make markets in 132 common stocks. Stip. ¶ 66.

64. As of March 31, 2003, there were a total of seven specialist firms that made markets for the 2,567 total common stocks traded on the NYSE. Stip. ¶ 67.
65. For each stock for which MMM is a registered specialist, MMM is obligated by NYSE rules to maintain a fair and orderly market in those stocks. Stip. ¶ 68.
66. As a specialist, MMM maintains a fair and orderly market of securities. Stip. ¶ 69.
67. MMM, in its role as a specialist, performs four key roles on the trading floor: (1) auctioneer; (2) catalyst; (3) agent; and (4) principal. Stip. ¶ 70.
68. In its role as an auctioneer, MMM:
- continually shows the best bids and offers throughout the trading day. These quotes are disseminated electronically through the NYSE quote and other market data systems that transmit the information instantly worldwide. Stip. ¶ 71.
 - maintains order in the crowd and interacts with other agents representing customers. Stip. ¶ 72.
 - makes sure that all marketable orders are executed regardless of their size. Stip. ¶ 73.
 - does not receive any compensation. Stip. ¶ 74.
69. In its role as a catalyst, MMM:
- is the contact point between brokers with buy orders and brokers with sell orders. Stip. ¶ 75.
 - brings together buyers and sellers when necessary. For example, if a buy or sell order cannot be matched with other orders, MMM will alert investors who were recently active in the stock to see if they can be brought into that transaction. Stip. ¶ 76.
 - earns no income. Stip. ¶ 77.
70. In its role as an agent, MMM:

- acts as a broker on behalf of a customer's order in the auction market crowd. Stip. ¶ 78.
- accepts limit orders from investors, either electronically or via a broker, and executes trades on their behalf when the share price reaches the investor's limit. Stip. ¶ 79.
- earns a piece of the broker's commission for performing a service. Stip. ¶ 80. MMM's gross proceeds from serving as an agent is its share of the broker's commission. Stip. ¶ 81.

71. In its role as a principal, MMM:

- must buy and sell stock against the market trend to cushion temporary imbalances and avoid unnecessary price variations. Stip. ¶ 82.
- is required to use its own firm's capital to minimize imbalances that occur when either: (i) buy orders temporarily outpace sell orders in a specialist's assigned stock; or (ii) sell orders temporarily outpace buy orders in a specialist's assigned stock. Stip. ¶ 83.
- held equity securities primarily for making long-sales to customers. Stip. ¶ 87.

72. To minimize imbalances, MMM buys and sells stock against the trend of the market until a price is reached at which public supply and demand are once again in balance. Stip. ¶ 84.

73. About 20 percent of the time, there are no other public buyers or sellers, and a specialist such as MMM must step in to buy or sell securities out of their own account. Stip. ¶ 85.

74. MMM cannot trade ahead of public orders. The NYSE operates under strict public-order priority that always puts the customer first. Stip. ¶ 86.

75. When MMM makes long-sales of equity securities to customers, it acts as a securities dealer. Stip. ¶ 88.

76. Pursuant to IRC § 1236, MMM reports its income from selling securities to customers in the ordinary course of its business as ordinary income, and not as capital gain. Stip. ¶ 89.

77. In its role as a principal, MMM could sell a security “short.” With a short sale, MMM, on the trade date, sells securities that it does not own, and then on the settlement date, which is three days later, either: (i) borrows the securities from another securities holder to fulfill a transaction, or (ii) buys the security in the marketplace (hopefully buying the securities at a price lower than the price at what MMM sold the securities). Stip. ¶ 90.

78. Approximately half of MMM’s security-sale transactions were short sales, and approximately half of MMM’s security-sale transactions were long sales. Stip. ¶ 91.

79. During the years in issue, all the securities that MMM purchased and later resold to its customers were held by JCC as available for sale to its customers. Stip. ¶ 92.

Facts Regarding the Inventory Issue

80. During the years in issue, taxpayer valued its securities reflected on its federal tax returns and its Forms 10-K at their fair market value. Stip. ¶ 108.

81. On its 1994 federal return, taxpayer reported that its balance sheet had ending balances (as of February 28, 1994) in the following amounts:

<u>Line</u>	<u>Description</u>	<u>Amount</u>
3	Inventories	-
9	Other Investments	24,825,527
14	Other Assets	<u>17,393,577</u>
	Subtotal	42,219,104

Stip. ¶ 109. Thus, taxpayer reported having no inventory in 1994. *Id.*

82. Taxpayer began to report amounts as “Inventory” on its 1995 federal return. Stip. ¶¶ 110-14. Taxpayer reported that its balance sheet had a beginning balance (as of March 1, 1994) in the following accounts as follows:

<u>Line</u>	<u>Description</u>	<u>Amount</u>
3	Inventories	7,298,079
9	Other Investments	24,468,659
14	Other Assets	<u>10,452,366</u>
	Subtotal	42,219,104

Stip. ¶ 110.

83. To obtain the beginning inventory balance of \$7,298,079 on its 1995 federal return (Schedule L), taxpayer reclassified two assets it previously reported as constituting something other than inventory. Stip. ¶¶ 111-114.

84. Specifically, it reclassified \$356,868, which represented a portion of XYZ’s asset called “Securities at FMV on Deposit from Clearing Orgs,” and which it had previously included as “Other Investments” on its 1994 federal return ending balance (Schedule L) to “Inventories.” Stip. ¶ 112.

85. Taxpayer also reclassified \$6,941,211, which represented the value of MMM’s asset called “Specialist Securities Long @ Mkt,” from “Other Assets” on its 1994 Federal Return balance sheet – ending balance (Schedule L) to “Inventory” on its 1995 Federal Return balance sheet – beginning balance (Schedule L). Stip. ¶ 113-14.

86. During the years in issue, taxpayer reported as a liability the fair market value of securities needed to close its short sales. Accordingly, for its federal tax returns, taxpayer included as an “Other Current Liability” its account called “Securities Sold But Not Yet Purchased.” Stip. ¶ 115.

Mark-to-Market

87. For financial reporting and tax reporting, ABC, XYZ, and JCC each valued their securities using the mark-to-market method. Stip. ¶ 116.
88. For federal tax reporting purposes, taxpayer reported its total assets as of February 28, 1994 as \$2,476,854,660. Stip. ¶ 117.
89. For financial reporting purposes, taxpayer reported its total assets as of February 28, 1994 as \$2,476,854,660. Stip. ¶ 118.
90. Taxpayer grouped its total assets as of February 28, 1994 into different account categories for federal income tax reporting purposes and 10-K reporting purposes; however, the total reported assets remained the same. Stip. ¶ 119.

Facts Regarding the Apportionment Factor Issue

1994 Tax Year

91. The parties agree that, for tax year ending 2/28/94:
- The Company and its Primary Subsidiaries were unitary. Stip. ¶ 120.
 - Taxpayer was subject to the general apportionment methodology, which is based on its payroll factor, its property factor, and its sales factor (double weighted). Stip. ¶ 121.
 - Taxpayer's Illinois property factor is 2.9979%. Stip. ¶ 122; Stip. Ex. 7, p. 1.
 - Taxpayer's Illinois payroll factor is 1.9044%. Stip. ¶ 123; Stip. Ex. 7, p. 1.
 - Taxpayer's sales factor numerator is \$3,528,791. Stip. ¶ 124; Stip. Ex. 7, p. 1.
92. The parties disagree about the correct value of taxpayer's sales factor denominator for 1994. Stip. ¶¶ 125-26. The Department values the denominator as \$266,534,017, and asserts that taxpayer's Illinois sales factor is 1.3240%. Stip. ¶ 125; Stip. Ex. 7, p. 1. Taxpayer values its 1994 sales factor denominator as

\$13,033,091,765, and asserts that its Illinois sales factor is 0.0271%. Stip. ¶ 126; Stip. Ex. 9, p. 4.

93. If the Department is correct, taxpayer is not entitled to the refund claimed on its 1994 Illinois amended return. Stip. ¶ 127. If taxpayer is correct, it is entitled to a tax refund of \$32,479, plus interest. Stip. ¶ 128.

1995 Tax Year

94. The parties agree that, for tax year ending 2/28/95:

- The Company and its Primary Subsidiaries were unitary. Stip. ¶ 129.
- Taxpayer was subject to the general apportionment methodology, which is a percentage based on its payroll factor, its property factor, and its sales factor (double weighted). Stip. ¶ 130.
- Taxpayer's Illinois property factor is 2.1055%. Stip. ¶ 131; Stip. Ex. 8, p. 1.
- Taxpayer's Illinois payroll factor is 1.7517%. Stip. ¶ 132; Stip. Ex. 8, p. 1.
- Taxpayer's sales factor numerator is \$3,548,981. Stip. ¶ 133; Stip. Ex. 8, p. 1.

95. The parties disagree about the correct value of taxpayer's sales factor denominator for the 1995 tax year. Stip. ¶¶ 134-35. The Department values taxpayer's 1995 sales factor denominator as \$309,315,614, and asserts that taxpayer's 1995 Illinois sales factor is 1.1474%. Stip. ¶ 134; Stip. Ex. 8, p. 1. Taxpayer values its 1995 sales factor denominator as \$12,315,601,042, and asserts that its Illinois sales factor is 0.0288%. Stip. ¶ 135; Stip. Ex. 10, p. 4.

96. If the Department is correct, taxpayer is not entitled to the refund claimed on its 1995 Illinois amended return. Stip. ¶ 136. If taxpayer is correct, it is entitled to a tax refund of \$27,865, plus interest. Stip. ¶ 137.

Sales Factor Controversy

97. On its original 1994 and 1995 Illinois income tax returns, taxpayer reported its security sales on a “Net Basis.” Stip. ¶¶ 138, 140; Stip Ex. 13 (deposition transcript of Department auditor Angele Morgan (“Morgan”)), Ex. 1 thereto (Morgan’s auditor’s report, dated October 22, 1999), p. 5. The parties define “Net Basis” or “Net” as meaning that the gross proceeds from a particular security sale are reduced by Taxpayer’s cost of the security. Stip. ¶ 138. Put another way, the “net” method uses profits, not gross receipts, within each half of the apportionment fraction. *See* Stip. ¶¶ 145-46.
98. The parties agree that “Gross Basis” or “Gross” means that the proceeds from a sale of a particular security are not reduced by the cost of the security. Stip. ¶ 139.
99. The Department audited taxpayer for the years in issue. Stip. ¶ 141. As the Department was about to complete its audit, taxpayer raised the issue that sales should be reported on a gross basis, and that it did not agree with the net sales method. Stip. ¶ 142. That is to say, toward the end of the audit, taxpayer began to disagree with the apportionment method it used on its original Illinois income tax returns. *Id.*; Stip. ¶¶ 138, 140; Stip. Ex. 13, Ex. 1 thereto, p. 5.
100. Taxpayer paid the audit liability and filed amended returns to pursue the net versus gross issue. Stip. ¶¶ 143-44. On those amended returns, taxpayer adjusted its sales factor by reporting its securities sales on a “Gross Basis.” Stip. ¶ 144.

101. The following table reflects, *inter alia*, the effect of calculating taxpayer's sales factor denominator for 1994 using the Gross Basis versus the Net Basis methods:

Year Ending 2/28/94	Gross Basis (Cost + Gain)	Net Basis (Gain)	Difference (Cost of Securities)
Sales of Securities			
ABC	\$ 432,438,378	\$ 7,392,307	\$ 425,046,071
XYZ	144,146,126	2,791,278	141,354,848
MMM	<u>12,230,684,846</u>	<u>30,528,017</u>	<u>12,200,156,829</u>
Subtotal: Sales of Securities	\$ 12,807,269,350	\$ 40,711,602	\$ 12,766,557,748
Other Income Sources			
Service Income	143,130,403	143,130,403	-
Municipal Bond Interest	703,828	703,828	-
Other Business Receipts	<u>81,988,184</u>	<u>81,988,184</u>	-
Subtotal: Other Income	\$ 225,822,415	\$ 225,822,415	-
Total Sales Using Each Method	\$ 13,033,091,765	\$ 266,534,017	\$ 12,766,557,748
Income From Securities Sales as % of Other Income		18%	

See Stip. 145.

102. The following table reflects, *inter alia*, the effect of calculating taxpayer's sales factor denominator for 1995 using the Gross Basis versus the Net Basis methods:

Year Ending 2/28/95	Gross Basis (Cost + Gain)	Net Basis (Gain)	Difference (Cost of Securities)
Sales of Securities			
ABC	\$ 166,088,848	\$ 7,271,642	158,817,206
XYZ	55,362,949	2,924,408	52,438,541
MMM	<u>11,824,189,478</u>	<u>29,159,797</u>	<u>11,795,029,681</u>
Subtotal: Sales of Securities	\$ 12,045,641,275	\$ 39,355,847	\$ 12,006,285,428
Service Income	132,339,343	132,339,343	-
Municipal Bond Interest	2,383,439	2,383,439	-
Other Business Receipts	<u>135,236,985</u>	<u>135,236,985</u>	-

Subtotal: Other Income	\$ 269,959,767	\$ 269,959,767	
Total Sales Using Each Method	\$ 12,315,601,042	\$ 309,315,614	\$ 12,006,285,428
Income From Securities Sales as % of Other Income		15%	

See Stip. ¶ 146

103. During 1994, taxpayer realized \$ 40,711,602 of apportionable business income from selling securities and \$ 225,822,415 of apportionable business income from other sources. Stip. ¶ 145. That is, about 18% of such income was derived from selling securities. *Id.* ($40,711,602 / 225,822,415 \approx 0.180281$ or 18%).
104. During 1995, taxpayer realized \$ 39,355,847 of apportionable income from selling securities and \$ 269,959,767 of apportionable income from other sources. Stip. ¶ 146. That is, about 15% of such income was derived from selling securities. *Id.* ($39,355,847 / 269,959,767 \approx 0.145784$ or 15%).
105. For Illinois purposes, taxpayer's sales factor numerator remains the same for both of the years at issue, regardless whether taxpayer's sales of securities are reported at gross or net, because the transactions at issue occurred outside of Illinois. Stip. ¶ 147; *id.* ¶¶ 124, 133.

Conclusions of Law:

The prima facie correctness of the Department's determinations was established when the Department introduced the denial into evidence at hearing. Stip. Ex. 14; 35 ILCS 5/904(a), 909(e)-(f). Thereafter, the burden lay with ABC to establish the correctness of its amended returns. See Balla v. Department of Revenue, 96 Ill. App. 3d 293, 296, 421 N.E.2d 236, 238 (1st Dist. 1981) (*citing* Telco Leasing, Inc. v. Allphin, 63

Ill. 2d 305, 347 N.E.2d 729 (1976); Bodine Electric Co. v. Allphin, 81 Ill. 2d 502, 410 N.E.2d 828) (1980)).

ABC makes three arguments why the Department's denial was in error. First, it argues that IITR § 100.3380(c)(5) does not apply to the income from its sales of securities as a principal. Taxpayers' Post-Hearing Brief ("Taxpayer's Brief"), pp. 23-25. Second, it argues that, even if IITR § 100.3380(c)(5) does apply, the regulation is ineffective here because it is invalid. *Id.* pp. 25-31. Finally, it argues that, even if the regulation is facially valid, the Department's application of the regulation in this case violates the uniformity clause of the Illinois Constitution. *Id.* pp. 31-35. I address each argument in turn.

Does IITR § 100.3380(c)(5) Apply to the Income at Issue?

The applicable special rule, IITR § 100.3380(c)(5), provides, in pertinent part:

c) Sales factor. The following special rules are established in respect to the sales factor in IITA Section 304(a)(3):

(5) In the case of sales of business intangibles (including, by means of example, without limitation, patents, copyrights, bonds, stocks and other securities), gross receipts shall be disregarded and only the net gain (loss) therefrom shall be included in the sales factor.

Example: In 1990, Corporation A, a calendar year taxpayer, sells stock with an adjusted basis of \$98,000,000 for \$100,000,000, realizing a federal net capital gain of \$2,000,000. Only the net capital gain of \$2,000,000 is reflected in A's sales factor for the taxable year ending December 31, 1990.

86 Ill. Admin. Code § 100.3380(c)(5).

ABC argues that IITR § 100.3380(c)(5) does not apply to the income at issue because the income the subsidiaries earn is ordinary income and not capital gains.

Taxpayer’s Brief, p. 23. To support the proposition that “the Taxpayer realizes ‘ordinary income’ and not ‘capital gain’ from their sales of business intangibles[,]” ABC cites stipulation number 89. *Id.* In that stipulation, the parties agreed that, “Pursuant to IRC [§] 1236, MMM reports its income from selling securities to customers in the ordinary course of its business as ordinary income, and not as capital gain.” Stip. ¶ 89.

The first thing to note about ABC’s implied argument that *all* of the income that the three subsidiaries realize from selling securities constitutes ordinary income (Taxpayer’s Brief, p. 23, Stip. ¶¶ 145-46), is that only one stipulation directly addresses the point, and that single stipulation provides that *MMM* reports such income as ordinary income. *Compare* Stip. ¶¶ 89, 145-46 *with* Stip. ¶¶ 31-32, 49-51. And while taxpayer stipulates that both XYZ and ABC earn gain or loss from selling securities as a principal (Stip. ¶¶ 31-32 (ABC), 49-51 (XYZ)), there are no stipulations that those companies reported such gains as ordinary income. *See* Stip. ¶¶ 26-34 (stipulations regarding ABC’s securities sales as either broker or principal, and income therefrom), ¶¶ 48-55 (stipulations regarding XYZ’s securities sales as a principal, and income therefrom). Now, the stipulations show clearly that most of the gain earned by the primary subsidiaries was earned by MMM. Stip. ¶¶ 145-46. But given the careful phrasing of the parties’ stipulations, I do not consider the absence of a stipulation that ABC and XYZ reported the gains each realized from selling securities as ordinary income to be a mistake or an oversight. While the facts unequivocally show that MMM’s gain from selling securities to customers in the ordinary course of business is ordinary income, and not capital gain (Stip. ¶ 89), no stipulation supports a similar conclusion regarding the gain earned by ABC or by XYZ from selling securities to customers.

But even if all of the income from the group's sales of securities constitutes ordinary income, taxpayer is flat-out wrong when it implies that income from the sale of a non-capital asset — for example, the gain MMM realized from making long sales of securities — is not “gain” as that term is used in ITR § 100.3380(c)(5). That such income constitutes gain is made clear by reviewing, *inter alia*, 26 U.S.C. § 1236, which provides that:

Dealers in securities

(a) Capital gains

Gain by a dealer in securities from the sale or exchange of any security shall in no event be considered as gain from the sale or exchange of a capital asset unless –

(1) the security was, before the close of the day on which it was acquired (or such earlier time as the Secretary may prescribe by regulations), clearly identified in the dealer's records as a security held for investment; and

(2) the security was not, at any time after the close of such day (or such earlier time), held by such dealer primarily for sale to customers in the ordinary course of his trade or business.

26 U.S.C. § 1236; *see also* 26 U.S.C. § 1221 (definition of capital asset). Similarly, Black's Law Dictionary defines gain as “Profits; winnings; increment of value. Difference between receipts and expenditures; pecuniary gain. Difference between cost and sale price. Appreciation in value or worth of securities or property. ***” Black's Law Dictionary 610 (5th ed. 1979). As a matter of simple definition, the income that the ABC group derives from selling securities as a dealer is gain, just not gain of a capital nature. *Id.*; 26 U.S.C. §§ 1221, 1236.

But even more importantly, the single example listed as part of ITR § 100.3380(c)(5) is just that — an illustration of what the regulation requires, or how it should be applied. Nothing within the substantive text reflects that the example was

intended to be a limiting or collectively exhaustive statement of the myriad types of gains and/or losses that persons might realize from selling any type of intangible asset. Moreover, where the Department intends an example, or a series of examples, to be an exhaustive statement of the types of situations that a more general statement embraces, it plainly says so. *E.g.*, 86 Ill. Admin. Code §§ 100.2470(c) (“... Following is a list (intended to be exhaustive) of exempt income and the specific statutes to which each item relates:”); 100.9710 (after quoting the IITA’s definition of a “financial organization,” the regulation states, “This definition constitutes an exclusive and exhaustive list of the types of organization which are ‘financial organizations’ under the Illinois Income Tax Act.”).

Here, however, the regulation’s substantive text provides that it is to apply “[i]n the case of sales of business intangibles (including, by means of example, without limitation, patents, copyrights, bonds, stocks and other securities)” 86 Ill. Admin Code § 100.3380(c)(5). The example provides an illustration of how the regulation would be applied in just one particular case. Thus, I cannot agree with taxpayer’s argument that IITR § 100.3380(c)(5) was meant to apply only to gains or losses from the sales of business intangibles that constitute capital assets.

Taxpayer further asserts that IITR § 100.3380(c)(5) does not apply because the purpose underlying that special rule is similar to the purpose underlying a regulation drafted by the Multistate Tax Commission. Taxpayer’s Brief, pp. 24-25. Taxpayer argues that,

*** The MTC’s regulation indicates that the MTC believed that there did not exist any distortion with a broker/dealer’s regular business activities that would warrant a *per se* special sales factor rule.

We suggest that the intent and purpose of [IITR] § 100.3380(c)(5) is the same as the MTC's Regulation § IV.18(c)(4), and accordingly that [IITR] § 100.3380(c)(5) was not meant to apply to [a] broker/dealer's non-treasury functions. ***

Taxpayer's Brief, p. 25.

The express terms of the Multistate Tax Commission's ("MTC") Regulation, however, are significantly different than the terms of IITR § 100.3380(c)(5). *Id.*, p. 24; MTC Regulation § IV.18(c)(4)(A), (C).² The different terms lead one reasonably to conclude that the policies underlying the MTC regulation taxpayer cites were *not* the same as the ones underlying the applicable Illinois income tax regulation.

In fact, the history of IITR § 100.3380(c)(5) contradicts taxpayer's suggestion that it was not meant to apply to the income at issue here. As it must when promulgating

² MTC Regulation § IV.18(c)(4)(A), (C) provides, in pertinent part:

(4) (A) Where gains and losses on the sale of liquid assets are not excluded from the sales factor by other provisions under Reg. IV.18(c)., such gains or losses shall be treated as provided in this subsection. This subsection does not provide rules relating to the treatment of other receipts produced from holding or managing such assets. If a taxpayer holds liquid assets in connection with one or more treasury functions of the taxpayer, and the liquid assets produce business income when sold, exchanged or otherwise disposed, the overall net gain from those transactions for each treasury function for the tax period is included in the sales factor. For purposes of this subsection, each treasury function will be considered separately.

(C) For purposes of this subsection, a treasury function is the pooling and management of liquid assets for the purpose of satisfying the cash flow needs of the trade or business, such as providing liquidity for a taxpayer's business cycle, providing a reserve for business contingencies, business acquisitions, etc. A taxpayer principally engaged in the trade or business of purchasing and selling instruments or other items included in the definition of liquid assets set forth herein is not performing a treasury function with respect to income so produced.

MTC Regulation § IV.18(c)(4)(A), (C) (available at <http://www.mtc.gov>) (link available as of 5/11/04).

regulations pursuant to the Illinois Administrative Procedures Act (“IAPA”), the Department published a Notice of Proposed Amendment, and, after the required notice and comment period, a Notice of Adopted Amendment, in the Illinois Register. 5 ILCS 100/5-35 – 5-50; 12 Ill. Reg. 2383 (¶ 5, Notice of Proposed Amendment to what was then IITR § 100.3700) (February 24, 1989); 12 Ill. Reg. 10952 (Notice of Adopted Amendments) (effective June 26, 1989). In each such notice published regarding what is now IITR § 100.3380(c)(5), under the heading, “A Complete Description of the Subjects and Issues Involved:” the Director explained that the proposed amendment, “Provides a special sales factor rule for gain from the sale of intangible assets in the ordinary course of a taxpayer’s business.” 12 Ill. Reg. 2383 (¶ 5, Notice of Proposed Amendment to what was then IITR § 100.3700) (February 24, 1989); 12 Ill. Reg. 10952 (Notice of Adopted Amendments) (effective June 26, 1989). Clearly, the pertinent regulation was always intended to apply to the gain — that is, *any* gain — from a taxpayer’s sales of business intangibles, and not just to capital gains therefrom. Similarly, the regulation was and remains designed to apply to gain from a taxpayer’s sales of any business intangibles in the ordinary course of its business, and not just those undertaken as part of the person’s treasury function. 12 Ill. Reg. 2383 (Notice of Proposed Amendment) (February 24, 1989); 12 Ill. Reg. 10952 (Notice of Adopted Amendments) (effective June 26, 1989).

And while taxpayer suggests possible purposes and policies that the Director might have had when he adopted IITR § 100.3380(c)(5) (*see* Taxpayer’s Brief, p. 25, *quoted supra*), it challenges the facial validity of the purpose the Director actually articulated for that regulation. Taxpayer’s Brief, p. 26 (taxpayer’s argument quoted and

discussed *infra*, pp. 29-32). The fundamental purpose for the regulation is found in the introductory subparagraph of IITR § 100.3380(a), which provides, in pertinent part, that:

The Director has determined that, in the instances described in this Section, the apportionment provisions provided in subsections (a) through (e) and (h) of IITA Section 304 do not fairly represent the extent of a person's business activity within Illinois. For tax years beginning on or after the effective date of a rulemaking amending this Section to prescribe a specific method of apportioning business income, all nonresident taxpayers are directed to apportion their business income employing that method in order to properly apportion their business income to Illinois. Taxpayers whose business activity within Illinois is not fairly represented by a method prescribed in this Section and who do not want to use that method for a tax year beginning after the effective date of the rulemaking adopting that method must file a petition under Section 100.3390 of this Part requesting permission to use an alternative method of apportionment.

86 Ill. Admin. Code § 100.3380(a).

The rationale for and policy underlying using only the net gain and/or loss from the sale of business intangibles reflect an attempt by the Director to avoid the distortion that would occur if the statutory gross receipts method was used to apportion such income. *Id.* One leading commentator has described the rationale underlying special apportionment rules such as IITR § 100.3380(c)(5), in such circumstances, as well as the nature the distortion they help to correct:

The reason for some states' limitation of receipts from intangibles that are includable in the sales factor is the potentially distorting impact that such receipts might otherwise have on the taxpayer's overall apportionment, when such receipts are assigned to a single state under the widely used commercial domicile rule. **This is because there is no necessary correlation between the amount of receipts and the corresponding amount of income from**

certain types of intangible investments. For example, the purchase at a discount of a thirty-day \$1 million certificate of deposit at the beginning of each month and its sale or redemption at the end of the month would yield \$12 million of receipts during the course of a year, whereas the purchase at a discount and subsequent sale or redemption of a one-year \$1 million certificate of deposit would yield only \$1 million of receipts. Yet the intangible interest income earned from these investments is likely to be quite similar and clearly will not vary by a factor of twelve.

J. Hellerstein & W. Hellerstein, State Taxation § 9.18[4][c] (section titled, “Quantum of Receipts From Intangibles Includable in Receipts Factor”) (3rd ed. 2003) (hereinafter “Hellerstein, State Taxation § []”) (emphasis added).

The single example listed in Professors Hellersteins’ treatise, moreover, should not be viewed as the only type of transaction that might produce distortion. The desire to achieve tax savings by, *inter alia*, manipulating apportionment factors is significantly greater, and ordinarily driven with more intellectual vigor, than a given state’s ability to timely appreciate — let alone police — the varied forms in which such attempts might appear. The avoidance of distortion, in turn, is premised upon the legislature’s desire:

***** to permit the fair determination of the portion of business income that is attributable to business activity in Illinois by the reporting member of the unitary group. The concern, it is emphasized, is in making a fair determination of tax liability.** This is why the legislature provided that, if the calculation of liability made by using the combined or unitary reporting method does not accurately and fairly represent the taxable business activity in Illinois, under section 304(e) of the Illinois Income Tax Act [now, § 304(f)] the taxpayer may petition that another method of determination be used.

Caterpillar Tractor Co. v. Lenkos, 84 Ill. 2d 102, 121, 417 N.E.2d 1343, 1353 (1981) (emphasis added).

Here, the Director created a special rule to apply broadly whenever persons apportion business income derived from their sales of business intangibles. Clearly, that special rule applies here. Illinois' policy of including only the net receipts to apportion the gain from the sales of business intangibles, moreover, should not be understood as being applicable only to gains from the sales of intangibles acquired as an investment, or, as taxpayer suggests, only to intangibles acquired and sold as part of the person's treasury function. 12 Ill. Reg. 2383 (February 24, 1989); 12 Ill. Reg. 10952 (effective June 26, 1989). The facts regarding this particular unitary business and the income derived from its various sources illustrate well how the gross receipts method distorts the comparative amount of a taxpayer's regularly transacted business activities conducted within the water's edge.

The ABC group operates a unitary business, with its principal members being ABC, MMM and XYZ. Stip. ¶¶ 4, 120, 129. ABC is a broker-dealer operating a multi-state discount brokerage service. Stip. ¶¶ 15-18. MMM is a registered broker-dealer, a member organization of the NYSE, and an authorized specialist on the floor of the NYSE. Stip. ¶¶ 55-60. MMM earns commission income when it acts as a customer's agent, and gain or loss when it acts as a principal. Stip. ¶¶ 88-89. XYZ clears securities transactions for ABC's customers, and for other customers. Stip. ¶ 40. XYZ earns income by lending funds to customers to buy securities on margin (Stip. ¶ 48) and it earns a commission when it settles a securities transaction between parties. Stip. ¶ 49. XYZ also acts as a principal with respect to certain types of transactions, including sales of fixed-income securities. Stip. ¶ 50. With respect to these principal transactions, XYZ

recognizes gain or loss based on the difference between the selling price and its cost price of the security. Stip. ¶ 52.

As a result of its unitary and inter-related operations, the ABC group realized business income gain in the amount of \$ 40,711,602 from selling securities during its 1994 tax year, and \$ 225,822,415 of apportionable business income from other activities. Stip. ¶ 145. During its 1995 tax year, ABC realized \$ 39,355,847 of apportionable gain from selling securities and \$ 269,959,767 of apportionable income from other sources. Stip. ¶ 146. That is, about 18% of ABC's apportionable business income was derived from selling securities in 1994 (Stip ¶ 145 ($40,711,602 / 225,822,415 \approx 0.180281$ or 18%)), and about 15% of its apportionable business income was derived from selling securities during 1995. Stip. ¶ 146 ($39,355,847 / 269,959,767 \approx 0.145784$ or 15%).

Thus, in both tax years at issue, taxpayer realized the lion's share of its apportionable business income from transactions that did not include its sales of securities as a principal. The parties stipulate that the income realized from the group's sales of securities as a principal occurred in a state other than Illinois. *See* Stip. ¶ 147. Presumably, the income-producing activities related to that income occurred in New York, though the record is not clear on the point. *See id.* By including the cost of the securities sold in the sales factor denominator, however, the gross receipts method mischaracterizes the facts about the comparative business activities that led to the production of the group's total apportionable income.

Specifically, using the gross receipts method grossly overstates the comparative amount and effect of the group's regular sales of securities as a principal vis-à-vis the comparative amount and effect of its other regular income-producing activities that led to

the production of most of the group's total apportionable net business income. Whereas 82% to 85% of the group's total apportionable net business income came from activities *other than* selling securities as a principal, the gross receipts method makes it appear as though the income from such activities constituted only 1.73% to 2.19% of its total sales everywhere. *See* Stip ¶¶ 145-46 ($225,822,415 / 13,033,091,765 \approx 0.017326$ or 1.73%; $269,959,767 / 12,315,601,042 \approx 0.021920$ or 2.19%). In that respect, the net receipts method required by IITR § 100.3380(c)(5) reflects a method of apportioning the ABC group's total unitary sales that more fairly reflects reality. *See Caterpillar Tractor Co. v. Lenkos*, 84 Ill. 2d at 121, 417 N.E.2d at 1353.

For the same reason, the gross receipts method distorts the nature and extent of the ABC group's activities in Illinois. The parties stipulate that taxpayer maintained about 2.9% of its property and 1.9% of its payroll in Illinois during 1994, and 2.1% and 1.75% of its respective property and payroll in Illinois during 1995. The parties further stipulate that, as a result of taxpayer's entire water's edge operations, it realized between 39 and 40 million dollars net profit from selling securities as a principal, and about 255 million and 269 million dollars net profit from other transactions during 1994 and 1995. Stip. ¶¶ 145-46. Heeding IITR § 100.3380(c)(5) when apportioning ABC's sales results in the determinations that 1.3% of its total water's edge sales were attributable to its activities in Illinois during 1994, and 1.1% of its total water's edge sales were attributable to its activities in Illinois during 1995. Stip. ¶¶ 125-26, 134-35. Thus, the net receipts method yields a rough yet intuitive congruity between the comparative amounts of the group's traditional business costs, i.e., payroll and property, and the comparative and logical effect of those costs, i.e., the production of business income. In contrast, using

the gross receipts method to apportion the comparatively smaller stream of income from the group's regular sales of securities makes it appear that only 0.0271% and 0.0288% of the ABC group's total sales were derived from its activities in Illinois. Stips. ¶¶ 145-46.

Note also the effect that using the statutory gross receipts method of apportionment would have on two persons in a situation similar to MMM. For example, consider two other specialists trading securities as principals, and with business income in the amount of approximately 40 million dollars therefrom. Each could have wildly different sales factor ratio, and correspondingly different liabilities for Illinois income and replacement taxes, based solely on the cost price of the securities each sold. A specialist in blue chip, or higher-priced securities, would have a much larger sales factor denominator, and thus, would pay a comparatively smaller share of its apportionable business income, than a specialist in securities having a significantly lower cost price. The net receipts apportionment method required by IITR § 100.3380(c)(5) would treat such similarly situated persons more fairly by considering within the sales factor only the profits received by such sales.

I conclude that including the cost of the securities MMM and others sold as principals within the sales factor denominator would significantly dilute the contribution that the ABC's group's sales and activities within Illinois made to its unitary business operations during the years at issue. In simple terms, using the statutory gross receipts method to apportion the business income from the ABC group's securities sales does not accurately and fairly reflect the extent of the group's taxable business activities in Illinois. 35 **ILCS** 5/304(f); Caterpillar Tractor Co. v. Lenkos, 84 Ill. 2d at 121, 417 N.E.2d at 1353.

Is IITR § 100.3380(c)(5) Invalid?

Taxpayer next argues that IITR § 100.3380(c)(5) does not apply because all of IITR § 100.3380 is invalid. It first argues that IITR § 100.3380 is invalid:

*** because it goes beyond the scope of the governing statute, 35 ILCS 5/304(f), insofar as the Department has already interpreted Section 304(f) to require that the party seeking to use alternative apportionment carries the burden of establishing gross distortion. See Ill. Admin. Code tit. 86, sec. 100.3390. Yet, in contrast and in conflict with [IITR] § 100.3390, by adopting [IITR] § 100.3380, the Department has conferred upon itself the power to mandate a taxpayer's use of alternative apportionment without the Department first establishing the existence of any grossly distorted result. ***

Taxpayer's Brief, p. 26.

ABC's argument is that the first clause of § 304(f), and/or IITR § 100.3390, act as a limitation on the Director's power to make a determination that a special apportionment method is required to prevent distortion, and that the Director's power may be exercised only after a factual showing, presumably in some type of hearing, that the statutory methods produce distortion. Taxpayer's Brief, pp. 26-30. But that interpretation of the IITA and IITR § 100.3390 ignores the Director's ability to exercise his discretionary § 304(f) power by using *either* the agency's administrative fact-finding procedures *or* its rule-making procedures.

Section 304(f) expressly grants the Director the authority to require the use of alternative apportionment methods "[i]f the ... apportionment provisions of subsections (a) through (e) and ... (h) [of IITA Section 304] do not fairly represent the extent of a person's business activity within [Illinois]" 35 ILCS 5/304(f). Section 1401 of the IITA expressly grants to the Department the authority to "make, promulgate and enforce

such reasonable rules and regulations ... relating to the administration and enforcement of the provisions of [the IITA], as it may deem appropriate.” 35 **ILCS** 5/1401(a). ABC, however, would have one conclude that § 304(f) reflects the legislature’s intent that the Director be *precluded* from declaring, in the form of a regulation, that an alternate method of apportionment is required because § 304’s apportionment methods do not fairly reflect the business activities of a particular class of persons, or of persons who conduct a particular class of transactions. Yet nothing within § 304(f) or IITR § 100.3390 prohibits the Director from “deem[ing] it appropriate” to exercise the power the legislature expressly granted to him in § 304(f) by way of rule-making. 35 **ILCS** 5/304(f), 5/1401(a); 86 Ill. Admin. Code § 100.3390(c). Perhaps the best evidence that taxpayer’s argument is wrong is found by reviewing past volumes of the Illinois Register, which would show that the Director has, for decades, done precisely what ABC implies he may not do. *See, e.g.*, 11 Ill. Reg. 12410 (July 24, 1987) (adopting, effective July 8, 1987, the special rule currently codified as 86 Ill. Admin. Code § 100.3380(d)).

ABC’s claim that IITR § 100.3380(c)(5) is invalid because it is contrary to IITR § 100.3390 is similarly mistaken. Sections 100.3380 and 100.3390 apply to different situations. Where either the Director or a taxpayer seek to use an alternative apportionment method *in a particular case*, IITR § 100.3390(c) places the burden on the Director, or the taxpayer, to show that the ordinary apportionment methods prescribed by § 304(a)-(e) would cause distortion of the person’s business activities within Illinois. 86 Ill. Admin. Code § 100.3390(c). On the other hand, IITR § 100.3380(a) applies when the Director’s determination of distortion has already been made pursuant to any of the properly promulgated administrative regulations set forth in IITR § 100.3380(b)-(e).

Compare 86 Ill. Admin. Code § 100.3380(a) *with* § 100.3390(c). In those instances, the burden is on a taxpayer to show that the required alternative apportionment method causes distortion. 86 Ill. Admin. Code § 100.3380(a). That showing is to take place following the taxpayer's filing of a petition for alternative apportionment, should it object to the particular special apportionment rule imposed by regulation. *Id.*³

In sum, since the different regulations clearly apply to different circumstances, the different provisions within ITR §§ 100.3380 and 100.3390 do not conflict with one another. Nor should they be read to create a conflict that may be remedied only if, as ABC would have it, ITR §§ 100.3380(a) and 100.3380(c)(5) are declared invalid because of ITR § 100.3390. *See Northwest Diversified, Inc. v. Mauer*, 341 Ill. App. 3d 27, 36, 791 N.E.2d 1162, 1169 (1st Dist. 2003) (where possible, courts must give effect to every word, clause, and sentence in a statute, and may not read it so as to render any part inoperative, superfluous, or insignificant.). As just discussed, the different regulatory sections are easily harmonized so as to give effect to each of them.

There are, of course, other reasons why I reject ABC's argument that ITR § 100.3380(c)(5) is invalid, chief among them being that, since an administrative agency is bound to follow its own regulations, an administrative law judge is powerless to declare the agency's properly promulgated regulation invalid. *See Department of Corrections v. Illinois Civil Service Commission*, 187 Ill. App. 3d 304, 308, 543 N.E.2d 190, 194 (1st

³ ABC, in fact, followed the procedures required by ITR § 100.3380(a) here, at least prior to the hearing. But at hearing, on the record, taxpayer withdrew its petition for alternative apportionment. Tr. pp. 6-8 (colloquy between counsel and ALJ). ABC thus abandoned its opportunity to claim that the application of ITR § 100.3380(c)(5) distorted the extent of its business activities in Illinois. 86 Ill. Admin. Code § 100.3900(b) ("The petition procedures provided in this Section are exclusive means by which a taxpayer may petition for an alternative apportionment formula. ***"). Instead, it chose to argue that ITR § 100.3380(c)(5) was inapplicable, invalid, or unconstitutional as applied here. *See Taxpayer's Brief, passim.*

Dist. 1989). More importantly, “administrative regulations, like statutes, are presumed to be valid, and the party challenging them has the burden of showing that they are [invalid].” Granite City Div. of Nat’l Steel Co. v. Illinois Pollution Control Bd., 155 Ill. 2d 149, 164, 613 N.E.2d 719, 726 (1993). “When an agency has acted in its rulemaking capacity, a court will not substitute its judgment for that of the agency. Regulations adopted by [an agency] pursuant to its statutory authority will not be set aside unless they are arbitrary and capricious.” *Id.*, at 162, 613 N.E.2d at 724.

Pursuant to the notice and comment provisions of the IAPA, the Director proposed and adopted a regulation that requires taxpayers who receive income in the form of gain from selling business intangibles to use a method of apportionment other than the one prescribed by IITA § 304(a)(3). 86 Ill. Admin. Code § 100.3380(c)(5); 12 Ill. Reg. 2383 (Notice of Proposed Amendment). When doing so, the Director properly invoked IITA § 304(f) as part of the statutory authority for his action. *Id.* (¶ 4 of each notice). That properly promulgated regulation has been in effect for almost fifteen years as this recommendation is being written. 12 Ill. Reg. 10952 (effective June 26, 1989).

Moreover, the Director’s requirement that persons include only the net receipts when apportioning the gain from the sales of business intangibles is based on sound economic realities. *See* Hellerstein, State Taxation § 9.18[4][c]. The Director created that special rule of apportionment pursuant to expressly granted powers within the IITA and the IAPA, and pursuant to the Director’s publicly stated determination that the use of the ordinary, statutory, method of apportioning such income would distort the person’s activities in Illinois. 86 Ill. Admin. Code §§ 100.3380(a), (c)(5). Even if I had the power to do so, I would not conclude that the special rule of apportionment set forth in IITR §

100.3380(c)(5) is invalid, either on its face or as applied in this matter.

Does the Application of IITR § 100.3380(c)(5) Here Violate the Uniformity Clause of Illinois' Constitution?

ABC's final argument is that, even if it is valid, applying IITR § 100.3380(c)(5) to the income in this case violates the Uniformity Clause of Illinois' Constitution because it taxes sellers of tangible inventories and sellers of intangibles inventories in a non-uniform basis. Taxpayer's Brief, p. 31.

Article IX, § 2 of the Illinois Constitution provides:

In any law classifying the subjects or objects of non-property taxes or fees, the classes shall be reasonable and the subjects and objects within each class shall be taxed uniformly. Exemptions, deductions, credits, refunds and other allowances shall be reasonable.

Ill. Const. 1970, art. IX, § 2. The class created by IITR § 100.3380(c)(5) does not affect the subject of the IITA (that is, persons who exercise the privilege of earning or receiving income in or as a resident of Illinois), but it does affect one of its objects, that is, the apportionment of income in the form of gain from a person's sales of business intangibles.

A tax classification is valid under the uniformity clause if (1) it is based on a real and substantial difference between the persons taxed and those not taxed, and if (2) the classification bears some reasonable relationship to the object of the legislation or to public policy. Geja's Café v. Metropolitan Pier & Exposition Authority, 153 Ill. 2d 239, 247, 606 N.E.2d 1212, 1215 (1992) (citing Searle Pharmaceuticals, Inc. v. Department of Revenue, 117 Ill. 2d 454, 468, 512 N.E.2d 1240 (1987)). The Court in Geja's Café referred to this two-part inquiry as the *Searle* test. Geja's Café, 153 Ill. 2d at 247, 606

N.E.2d 1212, 1216. The party challenging a classification on uniformity grounds has the burden of showing that the classification is arbitrary or unreasonable. *Id.*

ABC characterizes the classification created by IITR § 100.3380(c)(5) as being between sellers of tangible inventories and sellers of intangible inventories. Taxpayer's Brief p. 32 ("Illinois law violates the second prong of the reasonable classification requirement of the Uniformity Clause insofar as Illinois taxes on a non-uniform basis sellers of tangible inventories and sellers of intangible inventories."). I would merely phrase the classes differently. If IITR § 100.3380(c)(5) divides the universe of persons already subject to the IITA into two distinct classes, the line of demarcation is between persons who earn or receive income in the form of gain from selling business intangibles, and those who do not. ABC clearly belongs in the former class, since it realizes gain from selling business intangibles.

In Geja's Café, the Illinois Supreme Court held that:

upon a good-faith uniformity challenge, a taxing body must produce a justification for its classifications. The plaintiff then has the burden to persuade the court that the defendant's explanation is insufficient as a matter of law, or unsupported by the facts, to satisfy the *Searle* test. If the plaintiff is unable to do this, judgment is proper as a matter of law.

Geja's Café, 153 Ill. 2d at 248-49, 606 N.E.2d at 1216. The Director's statement as to why he adopted the special rule for apportioning gain from the sale of business intangibles, publicly expressed in IITR § 100.3380(a), constitutes strong justification for the classification. The Director has express authority to make such determinations, and he is required to announce them in accordance with the IAPA, when such determinations affect the general public. 35 **ILCS** 5/304(f), 5/1401(a); 5 **ILCS** 100/5-35 – 5-50. That

other states similarly distinguish between, and set up different methods for apportioning income from the sale of tangible property versus income in the form of gain from the sale of property other than tangible property, only reinforces the reasonable nature of such a classification. *See* Hellerstein, State Taxation § 9.18[4][c].

As described earlier, ABC responds to the Director's justification for ITR § 100.3380(c)(5) by challenging his authority to make it. Taxpayer's Brief, p. 26 (discussed *supra*, pp. 29-32). ABC validity arguments are, essentially, an argument that the Director's justification is insufficient as a matter of law. *See Geja's Café*, 153 Ill. 2d at 248-49, 606 N.E.2d at 1216. I have, however, previously rejected all of taxpayer's objections to the validity of ITR § 100.3380. *See, supra*, pp. 30-33.

In addition, ABC focuses on the fact that both its broker-dealers and sellers of tangible property carry the property they are engaged in the business of selling as inventory. *See* Stip. ¶¶ 108-116; Tr. pp. 135-50 (testimony of Leslie Schneider); *see also* 26 U.S.C. § 475. In effect, taxpayer argues that the factual similarity in the way that it and sellers of tangible property have to account for the property each is engaged in the business of selling precludes the Director from making any distinction, in this case, in the way that the income from such sales is apportioned.

ABC's factual argument, however, ignores that the regulatory classification is based on the nature of the property being sold, and not on how or whether the seller may be required to account for it. The question raised by ABC's challenge is whether a classification that treats persons who sell tangible property differently than those who sell intangible property is reasonably related to the Director's exercise of his discretionary § 304(f) power, or pursuant to Illinois public policy. I think that, as a matter of law, that

question must be answered in the affirmative. The most obvious example of Illinois' power to treat differently, for tax purposes, persons engaged in the business of selling tangible personal property versus persons engaged in the business of selling property other than tangible personal property, is the Retailers Occupation Tax Act ("ROTA"). 35 **ILCS** 120/1 *et. seq.*; Reif v. Barrett, 355 Ill. 104, 121-22, 188 N.E. 889, 897 (1933) (holding, *inter alia*, that the ROTA did not violate Illinois Constitution's Uniformity Clause). The ROTA was first enacted by the Illinois General Assembly in 1933, and has been in effect continuously since that year.

More specifically for income tax apportionment purposes, and for as long as the IITA has been in existence, Illinois has treated tangible personal property differently than intangible property. For example, the value of tangible personal property is includable within a person's property factor, whereas the value of its intangible property is not. 35 **ILCS** 5/304(a)(1)(A) (*formerly* Ill. Rev. Stat. ch. 120, ¶ 3-304(a)(1)(A) (1969)). More importantly, the statutory criteria for determining whether sales are considered to be in Illinois, for purposes of the Illinois sales factor, differ depending on whether the sales are sales of tangible personal property versus whether they are sales of property other than tangible personal property. *Compare* 35 **ILCS** 5/304(a)(3)(B) *with* 35 **ILCS** 5/304(a)(3)(C) (*formerly* Ill. Rev. Stat. ch. 120, ¶ 3-304(a)(3)(B), (C) (1969)). Thus, the classification set forth in IITR § 100.3380(c)(5) only mirrors the legislature's own statutory classification for determining the sales factor numerator.

Given Illinois' long history of making tax classifications based on the difference between sellers of tangible personal property and sellers of property other than tangible personal property, a regulation that apportions differently the income earned by such

persons could hardly be deemed unreasonable. This is especially true where the Director has determined that the statutory method of apportioning the gain from a person's sales of business intangibles distorts the extent of the seller's business activities in Illinois. 86 Ill. Admin. Code § 100.3380(a). I conclude, therefore, that IITR § 100.3380(c)(5)'s required alternate method of apportioning such gain is reasonably related to Illinois' policy of fairly determining and apportioning the business income of nonresident corporations. Caterpillar Tractor Co., 84 Ill. 2d at 121, 417 N.E.2d at 1353; 35 **ILCS** 5/304(f).

Conclusion:

The evidence admitted at this hearing demonstrate that the statutory method of using the gross receipts method to apportion the gain from the ABC group's sales of business intangibles, viz., securities, would distort the extent of the group's business activities in Illinois. I conclude that IITR § 100.3380(c)(5) applies to the income at issue, and that it constitutes a more fair and accurate method of apportioning that income. I reject taxpayer's arguments that that applicable regulation is facially invalid, or that it violates the Uniformity Clause of the Illinois Constitution, as applied here. I recommend, therefore, that the Director finalize the Department's prior denial of the group's amended Illinois income tax returns. Finally, I recommend that the Director deny taxpayer's petition for alternative apportionment.

Date: 6/14/2004

John E. White
Administrative Law Judge